Hughes Investment Advisory Service LLC

July 1, 2022

Dear Clients and Investors,

For Q2 the S&P 500 was down -16%. Bringing its first half loss to -20.6% - it's worse first half loss since 1970. NASDAQ is down -30% YTD and the AGG, or overall bond market, is now down -10.72% year-to-date. There was essentially no place to hide as every asset class was down significantly apart from oil and other commodities.

So that's what has happened so far in 2022 but what got us here and what can we expect in the second half of 2022?

I must say that I am not completely surprised at what has happened to the economy and the markets so far this year, but the downturn was sudden and the declines swift. We had the inflation call correct for the last 12 months but it wasn't until the Ukraine war broke out that everything came together creating the perfect inflation storm. Once the Fed realized their mistake of keeping rates too low for too long it was essentially too late to recover from this unforced error without negative consequences. Now we are faced with high inflation and low or negative growth. I believe that the US is now in recession or will be soon which will be confirmed when the second quarter GDP is tabulated sometime in the weeks ahead.

As for the second half there are at least two certainties: the Fed will be raising rates to fight inflation and company profits are going to decelerate. We can also expect a softer labor market, lower confidence and drawn-down savings weighing on consumer spending. Add to this a likely decline in the housing market, lower capital expenditures by businesses, stubbornly high inflation, higher interest rates and a recession is probable either now or in the second half of this year.

Will it be a serious downturn or a milder one? Unlike in 2008/09 the banks and financial system are stronger. Unlike in 2020 there is no pandemic. This recession should be milder. If we strip out the 2020 pandemic recession the case could be made that the economy is due for it's first slowdown since the great recession in 2008/09. Recessions are not unusual and are a necessary part of free market economies.

Taken together, this raises the question of whether the FED is raising rates just as the economy is rolling over and entering a recession? Historically at times like this the FED would be lowering rates to boost the economy but with inflation at 40-year highs they do

not have that option today, however, an economic contraction should spur the FED to slow the expected pace of interest rate increases, putting less downward pressure on the stock market and less upward pressure on bond yields, which move inversely to prices.

Some key additional mid-year 2022 data points:

- Estimated 2022 Q2 GDP growth -2.1% (Atlanta Fed Reserve GDP NOW)
- Estimated 2022 Q2CPI Inflation +8.3%
- 2022 S&P 500 Estimated Earnings of $229 – Yardeni Research Inc.

Now back to the question I posed 3 months ago:

"Soft Landing" What is a "Soft Landing"? In Fed speak a "soft landing" in the business cycle is the process of an economy shifting from growth to slow-growth to potentially flat, as it approaches but avoids a recession. It is caused by Federal Reserve attempts to slow down inflation. Last quarter I said **My best guess and base case scenario of the Fed achieving a "soft landing" result is 50/50 at best. This Quarter I'm revising that to a 33% chance of achieving the desired "soft landing" for the economy.**

What does this mean for our investment approach as we move into the second half of 2022? We've taken some profits in utilities and staples. Gold and commodities have been a disappointment. We're increasing bond exposure for the first time in many years because of higher yields. We're maintaining and buying solid equities as prices have corrected lower. We're correcting mistakes and taking advantage of buying opportunities as they present while upgrading the companies we own.

Is the damage done or is there another leg down ahead for stocks and bonds in the second half? My base case is that most of the damage is done. The Fed will continue raising rates but not nearly as much as the consensus now fears. Inflation will remain a problem but has or will peak as supply constraints ease and the war in Ukraine subsides. If the above case prevails, I believe that the second half, mostly in Q4, will prove to be positive for stocks and bonds and we can see a snap back rally that will bring the year end equity return close to breakeven or at a minimum reduce the current year loss significantly.

To be clear, the US and World economies are in a very difficult and challenging situation because of the Ukraine War, inflation and rising interest rates and there are many factors driving trading right now and making for a lot of uneven performances for stocks so far this year. Given the uncertainty of what the inflation and earnings data will show in the coming weeks our best course remains a cautious investment approach that includes a diversified portfolio of high-quality equities, inflation hedges, cash and now some bond

exposure. Primarily, if not solely, in US dollar-based assets. Why? The dollar is hitting all-time high levels against most major currencies and remains the world's premier currency. US companies are growing faster and have healthier more transparent balance sheets than foreign options and I believe that extreme risks are present with many investments outside the US.

Specifically, given the above concerns where do I find attractive investments and companies today? I'm focusing on equities with well-defined earnings prospects that can pass on higher input costs and prosper during periods of moderating economic growth and high inflation. Areas of focus include pharma, technology, defense, energy, infrastructure, and biotechnology. The Utility and Consumer Staples sectors have done very well of late, and we have taken profits. We are adding bond exposure for the first time in many years.

Overall, I continue to favor large-cap, dividend paying, US based multi-national companies with strong balance sheets. We love businesses with irreplaceable brand names, wide moats, high margins, grow their dividends, and have modest debt. Risk/reward now equally favors equities and fixed income. I believe that our portfolios are positioned to produce consistently attractive long-term risk adjusted returns while preserving capital. Please do not hesitate to give me a call to discuss the above analysis.

Sincerely,

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